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In the Supreme Court of the United States

OCTOBER TERM, 1979

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PORTLAND CEMENT COMPANY OF UTAH

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Tenth Circuit in this case.

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (App. A, *infra*, 1a-11a) is unofficially reported at 36 T.C.M. 578. The opinion of the court of appeals (App. B, *infra*, 12a-16a) is reported at 614 F.2d 724.

JURISDICTION

The judgment of the court of appeals was entered on February 5, 1980 (App. C, *infra*, 17a). By order dated April 24, 1980, Mr. Justice White extended the time for filing a petition for a writ of certio-

rari to and including June 4, 1980. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

Where the depletable "gross income from mining" under Section 613(c)(1) of the Internal Revenue Code of 1954 of an integrated miner-manufacturer of cement must be determined under the "proportionate profits" method, *i.e.*, an allocation of the receipts from the sale of its manufactured product to the mining phase of its operation in the ratio that its mining costs bear to its total (mining plus nonmining) costs:

1. Whether, in determining the amount of income to be allocated in accordance with the costs ratio, the income is to be computed on the assumption that only cement sold in bulk is respondent's first marketable product, as the decision below held, or that both bulk and bagged cement constitute respondent's first marketable product, in accordance with the governing Treasury Regulations.

2. Whether, in determining the ratio of mining to total costs, post-manufacturing costs of bags, bagging, storage, distribution, and sales should be included in the proportionate profits computation as nonmining costs, in accordance with the governing Treasury Regulations.

STATUTES AND REGULATIONS INVOLVED

The applicable provisions of Sections 611 and 613 of the Internal Revenue Code of 1954 (26 U.S.C.),

Treasury Regulations 118 (1939 Code), Section 39.23(m), and Treasury Regulations, Sections 1.613-3, 1.613-4, 1.613-5 (26 C.F.R.), are set forth at App. D, *infra*, 18a-43a.

STATEMENT

1. Respondent is a Utah corporation which is an integrated miner-manufacturer of Portland cement. For many years, it has engaged in the quarrying of an argillaceous rock, known as cement rock, and the processing of that rock into finished Portland cement (App. A, *infra*, 2a).

The mining phase of respondent's operations begins with the blasting of the cement rock from the face of the mountainous quarry owned by it. The loose rock is then fed through machinery which reduces the material to a size of less than one square inch. After transportation to a processing plant, the material is ground to a high degree of fineness. During the grinding process, water is added to the powder and a very fine mud, known as "slurry," is formed. The slurry is stored in tanks where it is continuously agitated to maintain a uniform texture. Respondent conducts frequent chemical analyses of the slurry to ensure that it is of a proper composition for making Portland cement (App. A, *infra*, 2a-3a).

During the manufacturing phase of respondent's operations, the liquid slurry is fed into rotary kilns and fired. The heat of the kiln expels moisture from the material and converts carbonates to oxides. As the material is heated to the point of fusion, a

hard glass-like substance, known as a clinker, is formed. The clinker is thereafter cooled and ground with purchased gypsum to produce finished cement. After the final grinding, respondent places its finished cement in storage silos to await sales to customers (App. A, *infra*, 3a-4a).

During the taxable years at issue, respondent sold its finished cement in two ways, either in bulk or in bags. Most of respondent's output was sold in bulk in tank cars, which were loaded directly from the storage silos. A small portion of the output was run from the storage silo into a bin above a bagging machine where it was sealed in paper bags in which it was thereafter sold (App. A, *infra*, 4a).

2. On its federal income tax returns for the taxable years ended March 31, 1970-1972, respondent computed its "gross income from mining" in accordance with the proportionate profits method set forth in Treasury Regulations, Section 1.613-4(d)(4) (26 C.F.R.) (App. D, *infra*, 35a-39a). This method has been prescribed by successive Treasury Regulations since 1940.[1] It allocates the sales price of the integrated miner-manufacturer's first marketable product between the mining and nonmining phases of its operations in the same ratio as the costs of its mining process bear to its total costs.

On its tax returns for the years in question, respondent took the position that bulk cement, and not

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[1] See Treasury Regulations 103 (1939 Code), Section 19.23(m)-1(f); Treasury Regulations 111 (1939 Code), Section 29.23(m)-1; Treasury Regulations 118 (1939 Code), Section 39.23(m)-1(e)(3), App. D, *infra*, 22a-24a.

bulk and bagged cement, constituted its first marketable product. It also excluded from the proportionate profits method formula the costs it incurred for storage, distribution and sales. Respondent reported a greater amount of "gross income from mining" (and thereby claimed a greater depletion base) by applying the proportionate profits computation to the gross sales price of its bulk cement and by excluding the costs of bags, bagging, storage, distribution, and sales from the total costs element of the formula (App. A, *infra*, 6a).

3. On audit, the Commissioner of Internal Revenue determined deficiencies in respondent's tax liabilities on the grounds that: (1) bulk and bagged cement constituted respondent's first marketable product, and (2) the costs of bags, bagging, storage, distribution and sales were includable in the "total costs" element in the formula. The Commissioner's computation yielded a reduced amount of "gross income from mining" and a correspondingly smaller depletion base (App. A, *infra*, 1a-2a, 6a).

Respondent thereafter brought this suit in the Tax Court for redetermination of the deficiencies. The Tax Court upheld respondent's computation and correspondingly larger depletion deduction. Invoking the *Golsen* rule,[2] pursuant to which the Tax Court follows the law of the circuit to which a case would be appealed, the Tax Court ruled that it was bound

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[2] See *Golsen* v. *Commissioner*, 54 T.C. 742 (1970), aff'd on other issues, 445 F.2d 985 (10th Cir.), cert. denied, 404 U.S. 940 (1971).

by *United States* v. *Ideal Basic Industries, Inc.*, 404 F.2d 122 (10th Cir. 1968), cert. denied, 395 U.S. 936 (1969) (Black and Harlan, JJ., dissenting; White and Marshall, JJ., not participating), rehearing denied, 396 U.S. 975 (1969); and *Portland Cement Co. of Utah* v. *United States*, 412 F.2d 894 (10th Cir. 1969). In so holding, the Tax Court rejected the Commissioner's argument that subsequent changes in the Treasury Regulations explicitly classifying the costs of bags, bagging, storage, distribution, and sales as nonmining costs made the *Golsen* rule inapplicable because the premises underlying the Tenth Circuit's earlier decisions were no longer valid (App. A, *infra*, 8a-11a).

The court of appeals affirmed (App. B, *infra*, 12a-17a), noting that "[w]e can add little, if anything, to the analysis made by the Tax Court" (App. B, *infra*, 13a-14a). In so ruling, it considered dispositive its earlier decision in *Ideal Basic Industries*, that " 'bulk cement' is marketable as such, and under the Regulations it is the 'first marketable product.' The bagged cement is the next stage, and it is, as the Tax Court indicated, the second marketable product" (App. B, *infra*, 14a-15a).

Adhering to the *Ideal Basic Industries* rationale, the court of appeals also rejected the Commissioner's argument that the cement in the bags is the same product as the cement in the bulk silos and his reliance upon Treasury Regulations, Section 1.613-4(d)(4)(iv) (App. D, *infra*, 37a-38a). That Regulation explicitly provides that "bulk and packaged products are considered to be essentially the same

product." As the court saw the matter, "[i]t is obvious that both are 'cement,' but it is equally apparent that it is 'first marketable' as bulk cement, not as bagged cement" (App. B, *infra*, 15a). The court of appeals further agreed with the Tax Court that the changes in the Regulations subsequent to the *Ideal Basic Industries* decision were not significant because they did not alter the definition of "first marketable product" (App. B, *infra*, 15a).

The court of appeals also affirmed the Tax Court's exclusive of respondent's bags, bagging, storage, distribution and sales costs from the "total costs" element in the proportionate profits formula. In support of this aspect of its holding, it adhered to its prior ruling in *Ideal Basic Industries* that "the costs of bagging and of bags were *not* mining costs, and should be excluded under an application of the proportionate costs doctrine" (App. B, *infra*, 15a; emphasis in original). In its view, "[t]hese costs thus had no part there in the determination of the income from the first marketable product. They have no part here when *Ideal Basic* is applied" (*ibid.*).

REASONS FOR GRANTING THE PETITION

The rulings below are variously in conflict with the decisions of the Courts of Appeals for the Third, Fourth and Ninth Circuits and the Court of Claims. The result is confusion and uncertainty in an area of tax law that affects, in the first instance, the numerous members of the integrated Portland cement in-

dustry who are located throughout the country. Potentially affected are all integrated miner-manufacturer industries to the extent that the proportionate profits method is necessarily applied in computing the depletion allowances of their members. This Court should resolve the conflict and establish a national rule so that the tax liabilities of integrated miner-manufacturers can be determined in a uniform manner.

1. In seeking review with respect to these questions, we recognize that the Court denied certiorari 11 years ago in a previous case decided by the court below, *United States* v. *Ideal Basic Industries, Inc.*, 404 F.2d 122 (10th Cir. 1968), cert. denied, 395 U.S. 936 (1969) (Black and Harlan, JJ., dissenting, White and Marshall, JJ., not participating), rehearing denied, 396 U.S. 975 (1969); and that the court of appeals upheld respondent's position on the authority of its earlier ruling in that case. If there were no developments since this Court's prior consideration of the matter, we would be reluctant to petition for certiorari a second time. The circumstances, however, have sufficiently changed to call for review by this Court of what has now apparently become a persistent refusal by the Tenth Circuit to accept the fundamental premises underlying the proportionate profits method.

(a) At the time the Court declined review in *Ideal Basic Industries*, there was an unacknowledged conflict between: (1) the court below and *Whitehall Cement Manufacturing Co.* v. *United States*, 369 F.2d 468 (3d Cir. 1966), with respect to the inclu-

sion of bagged cement in gross sales of the first marketable product; and (2) the court below, on the one hand, and *Whitehall Cement* and *Standard Lime & Cement Co.* v. *United States*, 329 F.2d 939 (Ct. Cl. 1964), on the other hand, with respect to the inclusion of post-manufacturing costs in the proportionate profits computation.

However, since the denial of certiorari in *Ideal Basic Industries*, two courts of appeals have explicitly rejected the Tenth Circuit's approach. Thus, in *United States* v. *California Portland Cement Co.*, 413 F.2d 161, 167-172 (1969), the Ninth Circuit held that the costs of bags and bagging cement, and the profits attributable to sale of bagged cement, must be included in the proportionate profits method and that such costs are allocable to the nonmining part of the taxpayer's operations.[3] The court also held that selling expenses must be included in the proportionate profits computation. Moreover, in *Arvonia-Buckingham Slate Co.* v. *United States*, 426 F.2d 484, 486-487 (1970), the Fourth Circuit held that selling and advertising expenses of an integrated miner-manufacturer must be included in the proportionate profits computation.

There is now a square conflict of decisions on both questions that has been explicitly acknowledged by the

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[3] The Ninth Circuit's decision in *California Portland Cement Co.* was issued on June 4, 1969, two days after this Court denied certiorari in *Ideal Basic Industries*. Although we called the attention of the Court to that decision in a petition for rehearing in *Ideal Basic Industries*, the Court denied rehearing (396 U.S. 975 (1969)) (White and Marshall, JJ., not participating).

Ninth and Fourth Circuits. Indeed, even the court below conceded as much—albeit reluctantly—observing that "[t]he Ninth Circuit has apparently reached a different result—at least as to non-mining costs—in *United States* v. *Calif. Portland Cement Co.*, 413 F.2d 161 (9th Cir.)" (App. B, *infra*, 14a). As long as the court below adheres to its lone position, the proportionate profits method, as established by the Treasury Regulations and approved by the other federal courts, will not be correctly applied in the Tenth Circuit. Thus, an integrated producer having a tax home there may have his constructive mining income and his depletion deduction improperly augmented and thereby enjoy a competitive advantage over similarly-situated taxpayers located outside the Tenth Circuit. Events during the past decade therefore demonstrate that the conflict will persist absent the establishment of a national rule by this Court.

(b) Moreover, since the Court's denial of certiorari in *Ideal Basic Industries*, the administrative importance of the questions presented has substantially increased. In our petition in that case (No. 1279, October Term 1968), we stated (page 17) that there were 22 similar cases presenting proportionate profits issues then being litigated involving more than $6 million in taxes. We are now advised by the Internal Revenue Service that there are currently 24 proportionate profits cases presently pending either in the courts or administratively with approximately $26 million at stake. The problem thus continues to affect a substantial number of tax-

payers with respect to which there has been more than a four-fold increase in the amount of revenue at issue. Since it will be impossible for the Treasury to administer the statute in an even-handed manner until the conflict is resolved, this Court should now settle the confusion and uncertainty that affects both the government and industry alike with respect to these important questions.

2. Section 611(a) of the Internal Revenue Code of 1954 (App. D, *infra*, 18a) authorizes a "reasonable allowance for depletion" of natural deposits "in all cases to be made under regulations prescribed by the Secretary or his delegate." In the case of hard minerals, the allowance is a specified percentage of "gross income from mining." Sections 613(a) and (b) of the 1954 Code (App. D, *infra*, 18a-19a). The rate for calcium carbonate rock, from which cement is made, was 15% for respondent's taxable year ended March 31, 1970, and 14% for its taxable years ended March 31, 1971 and 1972. Section 613 (b)(7) of the 1954 Code (App. D, *infra*, 19a-20a).

If a miner does not conduct manufacturing operations, *i.e.*, if he does not "destroy the physical or chemical identity of the minerals or permit them to be transformed into new products" (*United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, 86 (1960)), his "gross income from mining" is usually his actual gross receipts from the sales of the raw material. In the case of an integrated producer—one who does not sell the raw material he mines, but uses it in his own manufacturing operations—"gross income from

mining" is the producer's constructive income from the raw mineral product of his mining operations (*ibid.*).

The governing Treasury Regulations (Section 1.613-4(c) and Section 1.613-4(d), App. D, *infra*, 32a-39a) provide two methods for determining the constructive "gross income from mining" of an integrated miner-manufacturer. Under both methods the constructive figure is derived from actual sales data. If a representative price for the raw material is established by arm's-length sales in a relevant market —by the taxpayer or another miner—that price is the measuring-stick of constructive mining income for the raw mineral which the integrated producer uses in his own manufacturing operations. But if such a representative price cannot be established because the raw mineral is not generally sold on the open market—as in the integrated cement industry—then the producer's constructive mining income is derived under the proportionate profits method from his own sales price of his manufactured end product.

The objective of the proportionate profits method is to identify the portion of an integrated producer's gross sales that has been produced by the costs of his mining operations; that portion is the producer's constructive mining income. In substance, the method, long established under the Treasury Regulations, apportions gross sales receipts between mining and nonmining income in the same ratio as the producer's mining costs bear to its overall costs.

The apportionment is reflected in the following equation:

$$\frac{\text{Mining costs}}{\text{Total costs}} \times \text{Gross sales of cement} = \text{Gross income from mining}$$

Treasury Regulations, Section 1.613-4(d)(4)(ii) (App. D, *infra*, 37a); *Arvonia-Buckingham Slate Co.* v. *United States*, *supra*, 426 F.2d at 486; *United States* v. *California Portland Cement Co.*, *supra*, 413 F.2d at 167 n.2; *Whitehall Cement Manufacturing Co.* v. *United States*, *supra*, 369 F.2d at 471.

The basic theory of the method is that every dollar of the producer's costs, mining and nonmining alike, is deemed to produce the same proportionate part of the profits earned through sales of the first marketable product; and it is the gross receipts from such sales which are apportioned in accordance with the cost ratio. Treasury Regulations, Section 1.613.4(d)(4)(i) (App. D, *infra*, 35a-36a); *United States* v. *California Portland Cement Co.*, *supra*, 413 F.2d at 168; *Whitehall Cement Manufacturing Co.* v. *United States*, *supra*, 369 F.2d at 471-~~742~~; *United States* v. *Portland Cement Co. of Utah*, 378 F.2d 91, 92 (10th Cir.), cert. denied, 389 U.S. 975 (1967). The premise that every dollar of costs produces the same ratable part of the profits is in accord with long-settled principles of corporate accounting. See Paton and Littleton, *An Introduction to Corporate Accounting Standards* 67 (American Accounting Association 1940).

3. (a) The decision below that respondent's gross sales of cement should be determined on the assump-

tion that all its cement was sold in bulk is in conflict with the decisions of the Ninth Circuit in *California Portland Cement Co.* and the Third Circuit in *Whitehall Cement.* Like the decision below, the taxpayer in *California Portland Cement Co.* argued that its profits resulting from sales of bagged cement should be excluded from the proportionate profits formula on the ground that the first marketable product obtained from the calcium carbonate rock was bulk cement.

But the Ninth Circuit rejected this contention, citing with approval the explicit direction of Treasury Regulations, Section 1.613-3(d)(1)(iv) (App. D, *infra*, 25a) that "bulk and packaged products are considered to be essentially the same product" and that with respect to a cement manufacturer, "the finished cement of various types, *in bulk and bags*, constitutes the first marketable product or group of products produced by him" (emphasis added). In so ruling, the Ninth Circuit observed (413 F.2d at 169) that the treatment of bag and bagging costs by the court below in *Ideal Basic* was not consistent "with other language of that opinion * * *" that states that " 'the sales price of the first marketable product is to be computed on the identical physical material that is represented by total mining and nonmining costs' " (404 F.2d at 125 n.1). Moreover, the Ninth Circuit (413 F.2d at 170) agreed with the conclusion of the dissenting judge in *Ideal Basic* that "[t]o eliminate all post-manufacturing costs destroys consideration of the representative market or field price of the first marketable product, a prime factor

in the application of the equation, and thus seems * * * to reject the method itself" (404 F.2d at 128).[4]

In *Whitehall Cement*, the Third Circuit reached a similar conclusion prior to the 1968 promulgation of the definition of "first marketable product" in the Treasury Regulations.[5] There, the taxpayer likewise argued that the costs incident to and premiums charged for cement sold in bags should be excluded from the proportionate profits calculation, on the theory that the bagging costs were more than the premium so that those costs could not fairly be considered to have produced a proportionate share of the manufacturer's overall profits. The court rejected this argument as resting on (369 F.2d at 474) "an erroneous assumption that the packaging costs produced only the additional revenue derived from the premiums * * *. It seems reasonable to infer that the profits realized from the sale of packaged cement, and these were substantial, were attributable at least in part to the packaging costs." The court therefore

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[4] The decision below also conflicts with *General Portland Cement Co.* v. *United States*, 438 F. Supp. 27 (N.D. Tex. 1977), on appeal to the Fifth Circuit (No. 77-2831). There, the court stated: "To say that the cement in the truck and barge is the first marketable product is to defy the reality of the marketing process. Both large and small orders are sold as cement; the only difference between the two methods of sale is how the customer receives his cement. Different legal results which depend upon the mere size of the order of cement are simply not rational" (438 F. Supp. at 35).

[5] See T.D. 6965, 1968-2 Cum. Bull. 265. The current Regulations were promulgated in 1972 and are substantially the same. T.D. 7170, 1972-1 Cum. Bull. 178. They are retroactively applicable for all years governed by the 1954 Code.

held that the packaging costs must be included in the denominator of the proportionate profits equation as nonmining costs and that the profits attributable to such costs should be included in gross sales (*ibid.*).

(b) There is no basis for the theory upon which the decision below rests that cement in bulk is the first marketable product so that the bulk price should be the assumed price for all sales of cement. To begin with, that ruling cannot be squared with the Treasury Regulations defining first marketable product in the context of the cement industry that were issued pursuant to an express congressional authorization (Section 611(a)) to deal with "the multifarious circumstances which would involve questions of depletion" *Douglas* v. *Commissioner*, 322 U.S. 275, 281 (1944). As the Court has long recognized, such legislative Regulations are entitled to the same deference as the Code itself unless deemed to be arbitrary or contrary to the statutory authorization. *Commissioner* v. *South Texas Co.*, 333 U.S. 496, 501 (1948).

But wholly apart from the explicit command of the Regulations that we submit should govern here, the conclusion that cement in bulk is a qualitatively different product from cement sold in bags and is therefore respondent's first marketable product materially distorts the application of the proportionate profits method. Under that method, the nature of the first marketable product depends upon its physical and chemical characteristics. See *United States* v. *Cannelton Sewer Pipe Co.*, *supra*, 364 U.S. at 85-86. Neither the quantities nor the packages in which it

is sold, and which determine the per unit price, affect the nature of the product. Bulk cement and cement sold in bags is unquestionably the same product. The container for that product—whether it be a tank car supplied by the customer or a bag supplied by respondent—does not alter the physical and chemical characteristics of the cement. The proportionate profits method requires an allocation of the actual gross receipts received upon the sale of that product, and that must be determined, as it was in the Ninth and Third Circuits, solely on the basis of the prices in fact charged for the commodity regardless of variations depending upon such things as packaging. To exclude from gross sales any part of the sales proceeds of any cement will not yield the correct amount of gross income from mining under the proportionate profits formula upon which the statute allows percentage depletion.

4. The decision below to exclude post-manufacturing costs of bags, bagging, storage, distribution and sales from the proportionate profits computation is in conflict with the Ninth Circuit's decisions in *United States* v. *California Portland Cement Co.*, *supra*, 413 F.2d at 167-172 (costs of bags, bagging, and sales) and *Southwestern Portland Cement Co.* v. *United States*, 435 F.2d 504, 508-510 (1970) (costs of shipping, bags, bagging and selling); the Fourth Circuit's decision in *Arvonia-Buckingham Slate Co.* v. *United States*, 426 F.2d 484 (1970) (costs of advertising and sales); the Third Circuit's decision in *Whitehall Cement Manufacturing Co.* v. *United States*, 369 F.2d 468 (1966) (costs of bags, bagging, and bulk load-

ing); and the Court of Claims' decision in *Standard Lime & Cement Co.* v. *United States*, 329 F.2d 939 (1964) (costs of containers, packing, loading and storing).[6] These courts have held that these post-manufacturing costs were incurred to sell the first marketable product, that a proportionate part of the profits from the sale of the first marketable product is allocable to these costs, and that they should be included in the proportionate profits formula.[7]

There is no dispute that the costs of storing, shipping, bagging and bags are nonmining costs. The Treasury Regulations (Sections 1.613-4(d)(3)(i) and (iii), 1.613-4(g)(3) and (4), App. D, *infra*, 33a-35a, 42a-43a) so provide; and the court below as well as the other courts have so held. With respect to selling expenses, the Treasury Regulations

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[6] The decision below also conflicts with the following district court decisions: *General Portland Cement Co.* v. *United States*, 438 F. Supp. 27 (1977) (costs of bags, bagging, loading and storing); and *Mississippi Valley Portland Cement Co.* v. *United States*, 347 F. Supp. 240 (S. D. Miss. 1972) (costs of shipping, selling, marketing, and packaging).

[7] In *Standard Lime & Cement Co.* v. *United States*, 329 F.2d 939 (1964), the Court of Claims employed a computational approach different from the ratio formula set forth in the current Regulations and adopted by other courts under Treasury Regulations 118. This approach achieves the same end result, however, because the same basic theory was applied. *Standard Lime* reflects the literal description of the proportionate profits method in the 1939 Code Regulations. Under that description, post-manufacturing costs, together with their proportion of the profits, are subtracted from gross sales. This manner of working back from gross sales maintains the proper correspondence between a constructive income figure and related costs at any point in an integrated producer's operations.

(Section 1.613-4(d)(3)(iv) and 1.613-5(c)(4)(ii), App. D, *infra*, 35a-43a) provide that they are nonmining costs except when a taxpayer shows that an unintegrated miner or producer typically incurs selling expenses, in which case such expenses are allocated between mining and nonmining costs. Respondent, however, made no such showing in this case. Accordingly, the courts below correctly held them to be nonmining costs. The only question is whether these nonmining costs are included as such in the proportionate profits computation.

Contrary to the decision below, the Regulations and the cases including these costs in the formula are correct. No expenses may be eliminated from the proportionate profits method, for the underlying accounting theory is abrogated unless a producer's gross sales are allocated in accordance with a cost fraction which includes in its denominator *all* of the costs producing the sales. The determination of the integrated miner-manufacturer's "gross income from mining" requires an allocation of all its income from sales of the first marketable product between the mining and nonmining phases of the company's operations. All costs and all of the profit must be allocated to either the mining or the nonmining part of the operation. If an item of expense in fact results from the mining phase of the business, it should be included in the "gross income from mining," and also carry into "gross income from mining" its ratable share of the company's profit or loss. By the same token, every cost that is attributable to the non-

mining operations, together with its allocable share of profit or loss, must be excluded from the depletion base. Otherwise the proportionate profits formula will be distorted with the result that the depletion allowance will not be restricted to its intended ambit, the return of the miner's capital interest in depletable materials. *United States* v. *California Portland Cement Co.*, *supra*, 413 F.2d at 172.

Here, as in its previous decision in *Ideal Basic Industries*, the court below refused to recognize that all of the costs of producing and selling cement had to be taken into account in determining the costs ratio. It correctly reaffirmed its prior holding that "the costs of bagging and of bags were *not* mining costs * * *" (App. B, *infra*, 15a). But it erroneously refused to apply the basic theory of the proportionate profits method to these costs, in holding that they "should be excluded under an application of the proportionate costs doctrine" (*ibid.*).

By excluding these costs from the denominator (total costs) of the costs fraction, the decision below has in effect put part of the post-manufacturing costs and their allocable share of profits within respondent's depletion base. This distortion is a consequence of the court's requiring the allocation of sales income (erroneously limited to bulk cement) by a ratio that includes only mining and manufacturing costs in the denominator. As the dissenting judge observed in *Ideal Basic Industries*, in terms that are equally appropriate here, this decision "reaches a result that is a rejection of the basic theory of the

proportionate profit method itself" (404 F.2d at 127). The court of appeals' persistent rejection of this well-established method of computing the depletion deduction should not be permitted to stand.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

WADE H. MCCREE, JR.
Solicitor General

M. CARR FERGUSON
Assistant Attorney General

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JUNE 1980

APPENDIX A

T. C. Memo. 1977-137

UNITED STATES TAX COURT

Docket No. 6306-73

Filed May 9, 1977

PORTLAND CEMENT CO. OF UTAH, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Glen E. Fuller and *Jack R. Decker*, for the petitioner.

S. Clay Freed, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

FAY, *Judge*: Respondent determined deficiencies in petitioner's Federal income tax as follows:

FYE	Deficiency
March 31, 1970	$44,200
March 31, 1971	41,509
March 31, 1972	7,175

The deficiencies pertain to petitioner's method of computing percentage depletion under section 613.[1]

[1] All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

Specifically, we are to decide whether petitioner has made a proper application of the proportionate profits method of determining gross income from mining.

FINDINGS OF FACT

Petitioner is a Utah corporation which maintained its principal place of business at Salt Lake City, Utah, when the petition herein was filed. For each of the years in issue it filed a corporate income tax return with the Western Service Center, Ogden, Utah.

Petitioner is an integrated miner-manufacturer of Portland cement. It has for many years engaged in the quarrying of an argillaceous limestone rock,[2] known in the trade as cement rock, and in the processing of that rock into finished Portland cement.

The manufacture of Portland cement begins with the mining of cement rock. Petitioner obtains cement rock from its own quarry located 12 miles from its Salt Lake City processing plant. The cement rock is first blasted free of the mountainous quarry face, then pushed by bulldozer to the quarry floor. Secondary blasting is employed, if necessary, to further reduce the size of large boulders. The loose rock is then transported to "reduction" machinery where it passes through a jaw crusher and an impacter which further reduce the material to a size of less than one inch. The crushed material is

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[2] Referred to as "calcium carbonates" or "limestone" in sec. 613(b)(7), I.R.C. 1954.

stored temporarily at the quarry in bins awaiting loading into trucks for transportation to the processing plant.

Arriving at the processing plant, the material is unloaded and placed in open stockpiles. The material is then fed into rod-ball mills which grind the rock to a fineness so that 75 percent volume passes through a 200 mesh sieve. During this grinding process, water is added to the powder and a "slurry," a very fine mud, is formed. The slurry is stored in tanks where it is continually agitated to maintain a uniform mixture. The mining phase of the operation concludes at this point.

During the manufacturing phase, the liquid slurry is fed into rotary kilns and burned. The heat of the kiln expells moisture from the material and converts carbonates to oxides. As the material is heated to a point of incipient fusion, complex silicates and aluminates are formed by chemical reactions occurring inside the kiln. The result of the burning process is a hard, glass-like "clinker." The clinker is cooled and later ground with purchased gypsum to produce finished cement.

The rock in taxpayer's quarry varies in chemical composition. Certain areas within the quarry do not contain all the ingredients necessary to produce finished Portland cement. When rock is quarried from these areas it becomes necessary to add to the cement rock supplementary chemical materials. The various chemical supplements are added to the cement rock during the grinding phase in the rod-ball

mill. High lime rock is added to correct any calcium carbonate deficiency in the quarried rock; iron slag is added to correct any iron deficiency; silica is added to compensate for lacking silica oxides.

If the required amounts of calcium carbonates, iron and silica oxides are not present in the slurry as it is introduced into the kiln, chemical actions required to produce a clinker from which Portland cement can be made will not occur. It is only when the proper proportions of materials are introduced into the rod-ball mill that the necessary chemical reactions will take place during the burning in the kilns. Frequent chemical analyses are made by petitioner's chemists to ensure that the slurry is of a proper composition for making Portland cement.

After final grinding, finished cement is placed in storage silos to await sales to customers. Petitioner's finished cement is sold in two ways. Most of petitioner's output is sold in bulk in tank cars, loading directly from the storage silos. A small portion of the output is run from the storage silo into a bin above a bagging machine where it is sealed in paper bags and thereafter sold in that form.[3]

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[3] The parties have agreed upon the amounts of most of the expenses that are required in computing petitioner's depletion deduction. Since this controversy involves the application of the depletion computation, a recital of these amounts would not furnish an aid to an understanding of this case. Accordingly, they are not set forth in our findings of fact.

OPINION

In computing the amount of its gross income from mining, a component necessary to arriving at its percentage depletion allowance for the years in issue, petitioner utilized the proportionate profits method of computation. See sec. 613.

According to the regulations:

> The proportionate profits method of computation is applied by multiplying the taxpayer's gross sales * * * of his *first marketable product* or group of products * * * by a fraction whose numerator is the sum of all the costs allocable to those mining processes which are applied to produce, sell, and transport the *first marketable product* or group of products, and whose denominator is the total of all the mining and nonmining costs paid or incurred to produce, sell, and transport the *first marketable product* or group of products * * *. The method as described herein is merely a restatement of the method formerly set forth in the second sentence of Regulations 118, § 39.23(m)-1(e)(3) (1939 Code). The proportionate profits method of computation may be illustrated by the following equation:
>
> $$\frac{\text{Mining Costs}}{\text{Total Costs}} \times \text{Gross Sales} = \text{Gross Income from Mining.}$$
>
> [Sec. 1.613-4(d)4(ii), Income Tax Regs.; emphasis supplied.] [4]

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[4] The depletion regulations are legislative in nature, having the force and effect of law. Sec. 611(a).

The controversy in this matter centers on the costs which constitute "total costs" in the above formula. The resolution of this question depends in turn upon the meaning of the term "first marketable product" as stated in the regulation.

Petitioner sells finished cement both in bulk and in bags. Since the difference between the bulk and bagged price does not exceed the cost of the bags and bagging, petitioner would have a greater depletion base if the proportionate profits computation were applied to the value of its bulk cement, and the bags and bagging costs entirely excluded from the formula.

On its Federal income tax returns for the years in issue, petitioner took the position that bulk cement, rather than cement in bags, constituted its first marketable product, and applied the formula accordingly in computing its depletion deduction. Respondent, on the other hand, would have us include the costs of bags and bagging in the "total costs" portion of the formula, thereby decreasing the ultimate amount of "gross income from mining" and the corresponding depletion deduction. Additionally, respondent would further include in the formula the costs incurred in selling, shipping, and storing, along with the indirect costs attributable to these activities.

The taxpayer in this case maintains its principal place of business in Salt Lake City, Utah, and, therefore, an appeal of the decision herein would lie in the Tenth Circuit. The Court of Appeals for the

Tenth Circuit previously considered this issue in *United States* v. *Ideal Basic Industries, Inc.*, 404 F.2d 122 (10th Cir. 1968).[5]

In that case the court held bulk cement to be the first marketable product, stating at pages 125-126:

> We conclude that "first marketable product" is the proper sales price to which the application of the formula was intended, therefore, the costs of bags, bagging, and bulk loading should be eliminated from all parts in the formula. "Consequently we must hold that those packing and loading costs are indirect costs which are not incurred for the benefit of the entire operation and as such *cannot be included in taxpayer's computation of gross income* from the property at kiln feed." Standard Lime & Cement Co. v. United States, 329 F.2d 939, 948, 165 Ct. Cl. 180 (1964) (emphasis added); accord, United Salt Corp., 40 T.C. 359 (1963). Equally compelling is the simple logic that bulk cement is the first marketable product,[2] bagged cement is the second marketable product, as for example "sakrete"[3] would be a third marketable product.

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[2] Bulk cement is the first marketable product because it *can* be sold. * * *

[3] "Sakrete" is a bagged mixture of cement, sand, and gravel to which water may be added to make concrete.

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[5] See also *Portland Cement Company of Utah* v. *United States*, 412 F.2d 894 (10th Cir. 1969), in which the Tenth Circuit followed *United States* v. *Ideal Basic Industries, Inc.*, 404 F.2d 122 (10th Cir. 1968), in a subsequent case involving the petitioner herein on the identical issue.

In the present case petitioner contends simply that we are bound by this holding pursuant to the rule set forth in *Golsen* v. *Commissioner*, 54 T.C. 742 (1970), affd. 445 F.2d 985 (10th Cir. 1971), cert. denied 404 U.S. 940 (1971).

Respondent, relying on the holdings in *Commissioner* v. *Sunnen*, 333 U.S. 591 (1948), and *CBN Corporation* v. *United States*, 364 F.2d 393 (Ct. Cl. 1966), cert. denied 386 U.S. 981 (1967), contends that certain amendments to the pertinent regulations adopted subsequent to the Tenth Circuit's decision in *Ideal Basic* have worked a change in the legal atmosphere sufficient to cause the Tenth Circuit to reexamine their previously expressed position. As such, he argues, the Tenth Circuit's position insofar as we are concerned is no longer a foregone conclusion and the *Golsen* rule is therefore inapplicable in this instance.

Thus, at this point, it becomes our task to determine the extent, if any, by which the regulation changes have affected the definition of the term "first marketable product."

In 1972 the sections of the regulations dealing with the proportionate profits method of computation were revamped. At that time the main definitional portions of the regulations describing the proportionate profits method were carried over intact. Several new portions, however, were added.

In support of his position herein, respondent relies principally on the following language, added subse-

quent to the *Ideal Basic* decision, contained in section 1.613-4(d)(3)(iii)(a), Income Tax Regs.:

> (iii) In determining gross income from mining by use of methods based on the taxpayer's costs—
>
> > (a) The costs attributable to containers, bags, packages, pallets, and similar items as well as the costs of materials and labor attributable to bagging, packaging, palletizing, or similar operations shall be considered as nonmining costs.

Since this addition specifically states that the costs of bags and bagging are to be treated as nonmining costs, respondent concludes that such costs are now necessarily includable in the formula as an element of "total costs" rather than being eliminated entirely as the Tenth Circuit directed in *Ideal Basic*.

Respondent's view, however, overlooks a pivotal consideration. Notwithstanding the new regulation's specific mention of bags and bagging costs, such additional language does not purport to alter the definition of the makeup of the elements which constitute the first marketable product.[6] Rather, such change merely clarifies the classification among certain costs which are common to almost all integrated mining-manufacturing operations.[7]

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[6] Sec. 1.613-4(d)4(iv), which defines the term "first marketable product," was transferred completely intact from the old to the new regulatory material.

[7] Indeed, the Tenth Circuit takes no issue with the view that the cost of bags and bagging constitutes *nonmining* expenses. See *Ideal Basic Industries, supra* at 125.

Thus, once bulk cement is determined to be the first marketable product, the costs of bags and bagging become an element of producing a second marketable product—bagged cement; hence, these costs are of no consequence in determining gross income from the sale of the first marketable product. Given the fact that in the Tenth Circuit's view, bulk cement—the first marketable product—is produced before the bagging process commences, the amended regulation's mere reference to such bagging costs does not support respondent's claim for mandatory inclusion in the formula.

With regard to storing, shipping, and selling costs involved in the present case, the result is the same. As further stated in *Ideal Basic*:

> The advertising, promotional, and selling costs are not a proper part of the computation. These costs, like bagging (packing) and loading costs are overhead charges properly applicable to finished cement after it has become "first marketable product." * * *

Similarly, the court directed that the costs of operating storage warehouses and distribution terminals and the transportation en route be eliminated from the formula. 404 F.2d at 126.

We conclude that the issue herein was fully aired and decided by the Tenth Circuit in *Ideal Basic, supra.*[8] The premise underlying that decision re-

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[8] This case marks petitioner's sixth round in depletion-related litigation. See *Portland Cement Company of Utah* v.

mained unaffected by the regulation change. We are therefore bound to follow that decision in accordance with the requirements of *Golsen* v. *Commissioner, supra.*

To reflect the foregoing conclusions,

Decision will be entered under Rule 155.

United States, 412 F.2d 894 (10th Cir. 1969); *United States* v. *Portland Cement Company of Utah,* 378 F.2d 91 (10th Cir. 1967); 338 F.2d 798 (10th Cir. 1964); 315 F.2d 169 (10th Cir. 1963); 293 F.2d 826 (10th Cir. 1961).

APPENDIX B

PUBLISH

UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

No. 78-1290

PORTLAND CEMENT COMPANY OF UTAH,
a corporation, APPELLEE

v.

COMMISSIONER OF INTERNAL REVENUE, APPELLANT

On Appeal From The Decision Of The
United States Tax Court

[Filed Feb. 5, 1980]

David English Carmack, Department of Justice, Washington, D.C. (M. Carr Ferguson, Assistant Attorney General, Gilbert E. Andrews and Grant W. Wiprud, attorneys, Tax Division, Department of Justice, Washington, D.C., with him on the brief), for Appellant.

Glen E. Fuller, Salt Lake City, Utah, for Appellee.

Before SETH, Chief Judge, MCKAY and LOGAN, Circuit Judges.

PER CURIAM.

This is another chapter in the litigation concerning the application of the depletion allowance to the mining of cement rock and the manufacture of cement. The appellee in its brief states that this is its sixth appearance in this court on the issue. The fifth was in Portland Cement Co. of Utah v. United States, 412 F.2d 894 (10th Cir.). We also handed down an opinion in United States v. Ideal Basic Industries, Inc., 404 F.2d 122 (10th Cir.), under the 1968 Regulations. The issue before us is essentially the same as in the two cases cited.

This appeal is from the decision of the Tax Court entered in Docket No. 6306-73 as T.C. Memo 1977-137, 36 T.C.M. 578. This decision held that since the case arose in this circuit, it would be controlled by United States v. Ideal Basic Industries, Inc., 404 F.2d 122 (10th Cir.). The Tax Court held that the changes in the Treasury Regulations in 1972 (§ 1.613-4(d)(4)) would not bring about a change in the result reached in *Ideal Basic*. It determined that the basic consideration was that of the "first marketable product." It noted that the 1972 Regulations carried over the same provisions as were relied on in *Ideal Basic Industries* in the 1968 Regulations. We can add little, if anything, to the analysis

made by the Tax Court, and we agree with the conclusion reached. The Government here seeks to have another review of the *Ideal Basic* case, and of the previous case concerning this same appellee. The Ninth Circuit has apparently reached a different result—at least as to non-mining costs—in United States v. Calif. Portland Cement Co., 413 F.2d 161 (9th Cir.).

As the Tax Court indicated, the "pivotal consideration" is the determination under the Regulations of what is the "first marketable product." We expressly held in *Ideal Basic* that this product was "bulk cement." In the process followed by appellee, when the firing of the slurry in the kilns is complete, a clinker remains. This is then finely ground, and the product is finished cement. This goes into storage silos and is "bulk cement." It is loaded from these silos directly into tank cars and so sold in bulk to customers. Over 90% of appellee's sales are made in this manner. Some of the bulk cement is moved from the storage silos to a bin which is part of a bagging machine which in turn puts the cement into paper bags and seals the bags. The bagged cement is then sold as such to smaller users. The Government seeks to have "bagged cement" be the "first marketable product," and to so include the expenses associated with the bagging. This increase in expenses under the formula would reduce the depletion deduction.

As was held in our previous opinions, "bulk cement" is marketable as such, and under the Regulations it is the "first marketable product." The bagged cement

is the next stage, and it is, as the Tax Court indicated, the second marketable product.

The Government in its argument ignores the "first marketable" aspect of the Regulation, and would move to the second process—the bagging—because the cement in the bags is the same as in the bulk silos. It is obvious that both are "cement," but it is equally apparent that it is "first marketable" as bulk cement, not as bagged cement.

The Treasury Regulations were not changed since *Ideal Basic* as to the definition of "first marketable product." This portion of the old Regulations was carried over intact into the 1972 Regulations as § 1.613-4(d)(4)(iv). These provisions were the basis for the *Ideal Basic* decision, and no reason for a change has been presented.

The 1972 Regulations *added* § 1.613-4(d)(3)(iii)(a) relating to integrated mining activities in general. This provided that costs attributable to bagging, palletizing, etc., "shall be considered as nonmining costs." In *Ideal Basic*, we expressly held that the costs of bagging and of bags were *not* mining costs, and should be excluded under an application of the proportionate costs doctrine. These costs thus had no part there in the determination of the income from the first marketable product. They have no part here when *Ideal Basic* is applied.

The appellee expresses an unhappiness with the proportionate profits doctrine applied in *Ideal Basic* from the Treasury Regulations. It is, as therein described, artificial, but a device necessary for practical

administration. It is obviously unrealistic in some particular instances. As this appeal has developed, we will not consider it as an issue to be reviewed again.

AFFIRMED.

APPENDIX C

UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

January Term—February 5, 1980

Before The Honorable Oliver Seth, Chief Circuit Judge, The Honorable Monroe G. McKay, Circuit Judge, and The Honorable James K. Logan, Circuit Judge

PORTLAND CEMENT COMPANY OF UTAH, a corporation, PETITIONER-APPELLEE

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT-APPELLANT

JUDGMENT

No. 78-1290

This cause came on to be heard on the record on appeal from the United States Tax Court, and was argued by counsel.

Upon consideration whereof, it is ordered that the judgment of that court is affirmed.

/s/ Howard K. Phillips
HOWARD K. PHILLIPS
Clerk

APPENDIX D

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) *General Rule.*—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. For purposes of this part, the term "mines" includes deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under section 613(c). In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.

* * * * *

SEC. 613. PERCENTAGE DEPLETION.

(a) [as amended by Section 13(e), Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960] *General Rule.*—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property

excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). For purposes of a preceding sentence, the allowable deductions taken into account with respect to expenses of mining in computing the taxable income from the property shall be decreased by an amount equal to so much of any gain which (1) is treated under section 1245 (relating to gain from disposition of certain depreciable property) as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231, and (2) is properly allocable to the property. In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

(b) *Percentage Depletion Rates.*— * * *

* * * * *

(7) [as amended by Section 302(a), Public Debt and Tax Rate Extension Act of 1960, Pub. L. No. 86-564, 74 Stat. 290; Section 6(a), Act of September 2, 1964, Pub. L. No. 88-571, 78 Stat. 857; Sections 208(a) and 209(a), Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, 80 Stat. 1539. In effect for tax years beginning on or prior to October 9, 1969.] 15 percent—[a]ll other minerals (including, but not limited to, aplite, barite, borax, calcium carbonates, diatomaceous earth, dolomite, feldspar, fullers earth, garnet, gilsonite, granite, limestone, magne-

site, magnesium carbonates, marble, mollusk shells (including clam shells and oyster shells), phosphate rock, potash, quartzite, slate, soapstone, stone (used or sold for use by the mine owner or operator as dimension stone or ornamental stone), thenardite, tripoli, trona, and (if paragraph (1)(C) does not apply) bauxite, flake graphite, fluorspar, lepidolite, mica, spodumene, and talc, including pyrophyllite), except that, unless sold on bid in direct competition with a bona fide bid to sell a mineral listed in paragraph (3), the percentage shall be 5 percent for any such other mineral (other than slate to which paragraph (5) applies) when used, or sold for use, by the mine owner or operator as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes. For purposes of this paragraph, the term "all other minerals" does not include—

(A) soil, sod, dirt, turf, water, or mosses; or

(B) minerals from sea water, the air, or similar inexhaustible sources.

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(7) [as amended by Section 501(a), Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487; Section 501(b)(2), Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26. In effect for tax years beginning after October 9, 1969.] 14 percent—[a]ll other minerals, including, but not limited to, aplite, barite, borax, calcium carbonates, diatomaceous earth, dolomite, feldspar, fullers earth, garnet, gilsonite, granite, limestone, magnesite, magnesium carbonates, marble, mollusk

shells (including clam shells and oyster shells), phosphate rock, potash, quartzite, slate, soapstone, stone (used or sold for use by the mine owner or operator as dimension stone or ornamental stone), thenardite, tripoli, trona, and (if paragraph (1)(C) does not apply) bauxite, flake graphite, fluorspar, lepidolite, mica, spodumene, and talc (including pyrophyllite), except that, unless sold on bid in direct competition with a bona fide bid to sell a mineral listed in paragraph (3), the percentage shall be 5 percent for any such other mineral (other than slate to which paragraph (5) applies) when used, or sold for use, by the mine owner or operator as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes. For purposes of this paragraph, the term "all other minerals" does not include—

(A) soil, sod, dirt, turf, water or mosses; or

(B) minerals from sea water, the air, or similar inexhaustible sources.

(c) [as amended by Section 302(b)(1) and (2), Public Debt and Tax Rate Extension Act of 1960, *supra*] *Definition of Gross Income From Property.*—For purposes of this section—

(1) *Gross income from the property.*—The term "gross income from the property" means, in the case of a property other than an oil or gas well, the gross income from mining.

(2) *Mining.*—The term "mining" includes not merely the extraction of the ores or minerals from the ground but also the treatment processes considered as mining described in paragraph (4) (and the treatment processes necessary or incidental thereto), and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which such treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary or his delegate finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills.

* * * * *

(4) *Treatment processes considered as mining.*—* * *

* * * * *

(F) in the case of calcium carbonates and other minerals when used in making cement—all processes (other than preheating of the kiln feed) applied prior to the introduction of the kiln food into the kiln, but not including any subsequent process;

* * * * *

Treasury Regulations 118 (1939 Code):

§ 39.23(m)-1 *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.*

* * * * *

(e) As used in sections 114(b)(3) and 114 (b)(4)(A) and §§ 39.23(m)-1 to 39.23(m)-19, inclusive, the term "gross income from the property" means the following:

* * * * *

(3) If the taxpayer sells the crude mineral product of the property in the immediate vicinity of the mine, "gross income from the property" means the amount for which such product was sold, but, if the product is transported or processed (other than by the ordinary treatment processes described below) before sale, "gross income from the property" means the representative market or field price (as of the date of sale) of a mineral product of like kind and grade as beneficiated by the ordinary treatment processes actually applied, before transportation of such product (other than transportation treated, for the taxable year, as mining). If there is no such representative market or field price (as of the date of sale), then there shall be used in lieu thereof the representative market or field price of the first marketable product resulting from any process or processes (or, if the product in its crude mineral state is merely transported, the price for which sold) minus the costs and proportionate profits attributable to the transportation (other than transportation treated, for the taxable year, as mining) and the processes beyond the ordinary treatment processes. If the taxpayer establishes to the satisfaction of the Commissioner that another method of computation, other than the computation of profits proportionate to costs, clearly reflects the gross income from the prop-

erty, then such gross income shall be computed by the use of such other method.

* * * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.613-3. *Gross income from the property.*

* * * * *

(d) *Sales after the application of nonmining processes where a representative market of field price cannot be ascertained*—(1) *Computation of gross income from the property by use of the proportionate profits method.*

* * * * *

(iii) Those costs which are paid or incurred by the taxpayer to produce, sell, and transport the first marketable product or group of products, and which are not directly identifiable with either a particular mining process or a particular nonmining process shall be properly apportioned to mining and to nonmining. In the absence of any specific provision of this section providing an apportionment method, such costs shall be apportioned by use of a method which is reasonable in the circumstances. One method which may be reasonable in a particular case is an allocation based on the proportion that the direct costs of mining processes and the direct costs of nonmining processes bear to each other. For example, the salary of a corporate officer engaged in overseeing all of the taxpayer's processes is an expense which would normally be apportioned on the basis of the ratio between the direct costs of mining and nonmining processes.

On the other hand, an expense such as workmen's compensation premiums would normally be apportioned on the basis of direct labor costs. For the rule relating to selling expenses, see paragraph (c) of § 1.613-4.

(iv) As used in this section, the term "first marketable product or group of products" means the product (or group of essentially the same products) produced by the taxpayer as a result of the application of nonmining processes, in the form or condition in which such product or products are first marketed in significant quantities by the taxpayer or by others in the taxpayer's marketing area. For this purpose, bulk and packaged products are considered to be essentially the same product. The first marketable product or group of products does not include a product or group of products additionally refined, beneficiated, altered, or manufactured as a result of the application of additional nonmining processes. For example, if a cement manufacturer sells his own finished cement of various types in bulk and bags and also sells concrete blocks or dry ready-mix aggregates containing additivies, the finished cement of various types, in bulk and bags, constitutes the first marketable product or group of products produced by him. Similarly, if an integrated iron ore and steel producer sells both pig iron in various sizes and rolled sheet iron or shapes, his first marketable product is the pig iron in its various sizes. Further, if an integrated clay and brick producer sells both unglazed bricks and tiles of various shapes and sizes and additionally manufactured bricks and tiles which are specially

glazed, the unglazed products, both packaged and unpackaged, constitute his first marketable product or group of products.

(v) As used in this paragraph, the term "gross sales (actual or constructive)" means the total of the taxpayer's actual sales to others of the first marketable product or group of products, plus the taxpayer's constructive sales of the first marketable product or group of products used or retained for use in his own subsequent operations. The prices at which actual or constructive sales are made are to be determined in accordance with the principles set forth in this paragraph and in paragraphs (b), (c), and (e) of this section, as appropriate. In the case of constructive sales of the taxpayer's first marketable product or group of products, the taxpayer shall attach to his return a statement indicating the price or prices used by him in computing the representative market or field price for such product or products, and the source of his information as to such price or prices. The prices at which actual or constructive sales are made shall not be determined by reference to prices established in transactions between members of a controlled group. See paragraph (a) of § 1.482-1 for the definitions of the terms "controlled" and "group".

* * * * *

(4) *Treatment of particular items in computing gross income from the property by use of the proportionate profits method or another approved method based on the taxpayer's costs.* (i) Except as specifically provided elsewhere in this section, when determining gross income from

the property by use of the proportionate profits method or any other approved method which is based on the taxpayer's costs, the costs attributable to mining transportation shall be treated as mining costs, and the costs attributable to nonmining transportation shall be treated as nonmining costs. Accordingly, except as specifically provided elsewhere in this section, all profits attributable to mining transportation shall be treated as mining profits, and all profits attributable to nonmining transportation shall be treated as nonmining profits. For this purpose, mining transportation means so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to plants or mills in which other mining processes are applied thereto as is not in excess of 50 miles or, if the taxpayer files an application pursuant to paragraph (h) of this section and the Commissioner finds that both the physical and other requirements are such that the ores or minerals must be transported a greater distance to such plants or mills, the transportation over the greater distance. Further, for this purpose, nonmining transportation includes the transportation (whether or not by common carrier) of ores, minerals, or the products produced therefrom, from the point of extraction from the ground to nonmining facilities, or from a mining facility to a nonmining facility, or from one nonmining facility to another, or from a nonmining facility to the customers who purchase the taxpayer's first marketable product or group of products. See paragraph (e)(2) of this section for provisions relat-

ing to purchased transportation to the customer, and paragraph (g)(3) of this section for provisions relating to transportation the primary purpose of which is marketing or distribution. In the absence of other methods which the district director determines will clearly reflect the costs of the various phases of transportation, the cost attributable to nonmining transportation shall be an amount which is in the same ratio to the costs incurred for the total transportation as the distance of the nonmining transportation is to the distance of the total transportation. Where the plants or mills in which mining processes are applied to ores or minerals are in excess of 50 miles from the point of extraction from the ground (or in excess of a greater distance approved by the Commissioner), the costs incurred for transportation to such plants or mills in excess of 50 miles (or of such greater distance) shall be treated as nonmining costs in determining gross income from mining. Accordingly, all profits attributable to such excess transportation are treated as nonmining profits. However, except in the case of transportation performed in conveyances owned or leased by the taxpayer, the preceding sentence shall apply only to taxable years beginning after November 30, 1968.

* * * * *

(iii) In determining gross income from the property by use of the proportionate profits method (or any other approved method which is based on the taxpayer's costs)—

(a) The costs attributable to containers, bags, packages, pallets, and similar items as well as

the costs of materials and labor attributable to bagging, packaging, palletizing, or similar operations shall be considered as nonmining costs.

(b) The costs attributable to the bulk loading of manufactured products shall be considered as nonmining costs.

(c) The costs attributable to the operation of warehouses or distribution terminals for manufactured products shall be considered as nonmining costs.

Accordingly, all profits attributable thereto are treated as nonmining profits.

(iv) In computing gross income from the property by means of the proportionate profits method or any other approved method based on the taxpayer's costs, the principles set forth in paragraph (c) of § 1.613-4 shall apply when determining whether selling expenses and trade association dues are to be treated, in whole or in part, as mining costs or as nonmining costs. To the extent that selling expenses and trade association dues are treated as nonmining costs, all profits attributable thereto are treated as nonmining profits.

* * * * *

(e) *Reductions of sales price in computing gross income from the property*— * * *

* * * * *

(2) *Purchased transportation to the customer.* * * *

* * * * *

(ii) In the case of a taxpayer computing gross income from mining under the provisions of paragraph (d)(1) of this section, the cost of purchased transportation to the customer (as de-

fined in subdivision (iii) of this subparagraph) shall be excluded from the taxpayer's gross sales of his first marketable product or group of products (after any adjustments required by subparagraph (1) of this paragraph) and from the denominator of the proportionate profits fraction, without attributing profits to the cost of such transportation. Similar transportation cost adjustments may be made, if appropriate, in the case of methods of computation which are approved under paragraph (d)(2) of this section and which are based on the taxpayer's costs. For the treatment of costs and profits attributable to transportation which does not meet the requirements of subdivision (iii) of this subparagraph. See paragraph (d)(4)(i) of this section.

(iii) For purposes of this section, the term "purchased transportation to the customer" means, in general, nonmining transportation from the taxpayer's mine or plant to the customer—

(a) Which is performed in conveyances owned or leased by persons other than the taxpayer, rather than in conveyances owned or leased by the taxpayer;

(b) Which is performed solely to deliver the taxpayer's minerals or mineral products to the customer, rather than to transport such minerals or products for packaging or other additional processing by the taxpayer (other than incidental storage or handling); and

(c) Which is charged to the customer in such a way that the taxpayer ordinarily does not earn any profit with respect to such transportation.

For purposes of the preceding sentence, transportation which is performed by a person controlling or controlled by the taxpayer (within the meaning of paragraph (a)(3) of § 1.482-1) shall be deemed to have been performed in conveyances owned or leased by the taxpayer unless it is established by the taxpayer that the price charged by the controlling or controlled person for such transportation constitutes an arm's-length charge (under the standard described in paragraph (b)(1) of § 1.482-1). The term "purchased transportation to the customer" includes transportation to a warehouse, terminal, or distribution facility owned or operated by the taxpayer, provided that such transportation is performed under the conditions described in the first sentence of this subdivision. The taxpayer must demonstrate the nonprofit character of the transportation services, as described in (c) of this subdivision, in light of all the facts and circumstances. It shall be presumed that the requirements set forth in either (a) or (c) of this subdivision (relating, respectively, to conveyance ownership and profits) are not satisfied if the taxpayer requires customers to purchase minerals or mineral products only on a delivered basis, by failing to offer such minerals or products for sale on the basis of a price f.o.b. the taxpayer's mine or plant, or by other means. In the case of taxpayers computing gross income from mining under the provisions of paragraph (d) of this section, the term "purchased transportation to the customer" refers to transportation which conforms with the other requirements of this subdivision and which is performed to

transport the taxpayer's first marketable product or group of products (as defined in paragraph (d)(1)(iv) of this section) rather than to transport minerals or mineral products which do not yet constitute the taxpayer's first marketable product or group of products.

* * * * *

(g) *Nonmining processes*—* * *

* * * * *

(3) *Transportation for the purpose of marketing or distribution; storage.* Transportation the primary purpose of which is marketing, distribution, or delivery for the application of only nonmining processes shall not be considered as mining. Nor shall transportation be considered as mining merely because, during the course of such transportation, some extraneous matter is removed from the ore or mineral by the operation of forces of nature, such as evaporation, drainage, or gravity flow. Similarly, storage or warehousing of manufactured products shall not be considered as mining. The preceding sentence shall apply even though, during the course of such storage or warehousing, some extraneous matter is removed from the ore or mineral by the operation of forces of nature, such as evaporation, drainage, or gravity flow.

* * * * *

§ 1.613-4 *Gross income from the property in the case of minerals other than oil and gas.*

* * * * *

(d) *Cases where a representative market or field price cannot be ascertained*—* * *

* * * * *

(3) *Treatment of particular items in computing gross income from the mining by use of methods based on the taxpayer's costs.* (i) Except as specifically provided elsewhere in this section, when determining gross income from mining by use of methods based on the taxpayer's costs, the costs attributable to mining transportation shall be treated as mining costs, and the costs attributable to nonmining transportation shall be treated as nonmining costs. Accordingly, except as specifically provided elsewhere in this section, all profits attributable to mining transportation shall be treated as mining profits, and all profits attributable to nonmining transportation shall be treated as nonmining profits. For this purpose, mining transportation means so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to plants or mills in which other mining processes are applied thereto as is not in excess of 50 miles or, if the taxpayer files an application pursuant to paragraph (h) of this section and the Commissioner finds that both the physical and other requirements are such that the ores or minerals must be transported a greater distance to such plants or mills, the transportation over the greater distance. Further, for this purpose, nonmining transportation includes the transportation (whether or not by common carrier) of ores, minerals, or the products produced there-

from, from the point of extraction from the ground to nonmining facilities, or from a mining facility to a nonmining facility, or from one nonmining facility to another, or from a nonmining facility to the customers who purchase the taxpayer's first marketable product or group of products. See paragraph (e)(2) of this section for provisions relating to purchased transportation to the customer and paragraph (g)(3) of this section for provisions relating to transportation the primary purpose of which is marketing or distribution. In the absence of other methods which clearly reflect the costs of the various phases of transportation, the cost attributable to nonmining transportation shall be an amount which is in the same ratio to the costs incurred for the total transportation as the distance of the nonmining transportation is to the distance of the total transportation. As an example, where the plants or mills in which mining processes are applied to ores or minerals are in excess of 50 miles from the point of extraction from the ground (or in excess of a greater distance approved by the Commissioner), the costs incurred for transportation to those plants or mills in excess of 50 miles (or of that greater distance) shall be treated as nonmining costs in determining gross income from mining. Accordingly, all profits attributable to that excess transportation are treated as nonmining profits. However, except in the case of transportation performed in conveyances owned or leased by the taxpayer, the preceding

sentence shall apply only to taxable years beginning after November 30, 1968.

* * * * *

(iii) In determining gross income from mining by use of methods based on the taxpayer's costs—

(a) The costs attributable to containers, bags, packages, pallets, and similar items as well as the costs of materials and labor attributable to bagging, packaging, palletizing, or similar operations shall be considered as nonmining costs.

(b) The costs attributable to the bulk loading of manufactured products shall be considered as nonmining costs.

(c) The costs attributable to the operation of warehouses or distribution terminals for manufactured products shall be considered as nonmining costs.

Accordingly, all profits attributable thereto are treated as nonmining profits.

(iv) In computing gross income from mining by the use of methods based on the taxpayer's costs, the principles set forth in paragraph (c) of § 1.613-5 shall apply when determining whether selling expenses and trade association dues are to be treated, in whole or in part, as mining costs or as nonmining costs. To the extent that selling expenses and trade association dues are treated as nonmining costs, all profits attributable thereto are treated as nonmining profits.

* * * * *

(4) *Proportionate profits method.* (i) The objective of the "proportionate profits method"

of computation is to ascertain gross income from mining by applying the principle that each dollar of the total costs paid or incurred to produce, sell, and transport the first marketable product or group of products (as defined in subdivision (iv) of this subparagraph) earns the same percentage of profit. Accordingly, in the proportionate profits method no ranking of costs is permissible which results in excluding or minimizing the effect of any costs incurred to produce, sell, and transport the first marketable product or group of products. For purposes of this subparagraph, members of a controlled group shall be treated as divisions of a single taxpayer. See paragraph (j) of this section for the definitions of the terms "controlled" and "group."

(ii) The proportionate profits method of computation is applied by multiplying the taxpayer's gross sales (actual or constructive) of his first marketable product or group of products (after making the adjustments required by paragraph (e) of this section) by a fraction whose numerator is the sum of all the costs allocable to those mining processes which are applied to produce, sell, and transport the first marketable product or group of products, and whose denominator is the total of all the mining and nonmining costs paid or incurred to produce, sell, and transport the first marketable product or group of products (after making the adjustments required by this paragraph and paragraph (e) of this section). The method as described herein is merely a restatement of the method formerly set forth in the second sentence of Regulations 118, section 39.23(m)-1 (e)(3) (1939 Code). The pro-

portionate profits method of computation may be illustrated by the following equation:

$$\frac{\text{Mining Costs}}{\text{Total Costs}} \times \text{Gross Sales} = \text{Gross Income from Mining.}$$

(iii) Those costs which are paid or incurred by the taxpayer to produce, sell, and transport the first marketable product or group of products, and which are not directly identifiable with either a particular mining process or a particular nonmining process shall, in the absence of a specific provision of this section providing an apportionment method, be apportioned to mining and to nonmining by use of a method which is reasonable under the circumstances. One method which may be reasonable in a particular case is an allocation based on the proportion that the direct costs of mining processes and the direct costs of nonmining processes bear to each other. For example, the salary of a corporate officer engaged in overseeing all of the taxpayer's processes is an expense which may reasonably be apportioned on the basis of the ratio between the direct costs of mining and nonmining processes. On the other hand, an expense such as workmen's compensation premiums would normally be apportioned on the basis of direct labor costs. For the rule relating to selling expenses, see paragraph (c)(4) of § 1.613-5.

(iv) As used in this section, the term "first marketable product or group of products" means the product (or group of essentially the same products) produced by the taxpayer as a result

of the application of nonmining processes, in the form or condition in which such product or products are first marketed in significant quantities by the taxpayer or by others in the taxpayer's marketing areas. For this purpose, bulk and packaged products are considered to be essentially the same product. Sales between members of a controlled group (as defined in paragraph (j) of this section) shall not be considered in making a determination under this subdivision. The first marketable product or group of products does not include any product which results from additional manufacturing or other nonmining processes applied to the product or products first marketed in significant quantities by the taxpayer or others in the taxpayer's marketing area. For example, if a cement manufacturer sells his own finished cement in bulk and bags and also sells concrete blocks or dry ready-mix aggregates containing additives, the finished cement in bulk and bags, constitutes the first marketable product or group of products produced by him. Similarly, if an integrated iron ore and steel producer sells both pig iron in various sizes and rolled sheet iron or shapes, his first marketable product is the pig iron in its various sizes. Further, if an integrated clay and brick producer sells both unglazed bricks and tiles of various shapes and sizes and additionally manufactured bricks and tiles which are specially glazed, the unglazed products, both packaged and unpackaged, constitute his first marketable product or group of products.

(v) (a) As used in this subparagraph, the term "gross sales (actual or constructive)"

means the total of the taxpayer's actual competitive sales to others of the first marketable product or group of products, plus the taxpayer's constructive sales of the first marketable product or group of products used or retained for use in his own subsequent operations, subject to the adjustments required by paragraph (e) of this section. See (b) of this subdivision in the case of actual sales between members of controlled groups and in the case of constructive sales. A "constructive sale" occurs when a miner-manufacturer is deemed, for percentage depletion purposes, to be selling the first marketable product or group of products to himself.

(b) In the case of sales between members of a controlled group as to which the district director has exercised his authority under section 482 and the regulations thereunder and has determined the appropriate price with respect to specific sales transactions, that price shall be deemed, for those transactions, to be the actual amount for which the first marketable product or group of products is sold for purposes of this subdivision (v). In the case of all other sales between members of a controlled group, and in the case of constructive sales, the prices for such sales shall be determined by use of the principles set forth in paragraph (c) of this section, subject to the adjustments required by paragraph (e) of this section. In the case of constructive sales, see paragraph (c)(4) of this section for rules relating to information to be furnished by the taxpayer.

* * * * *

(e) *Reductions of sales price in computing gross income from mining*—* * *

* * * * *

(2) *Purchased transportation to the customer.* * * *

* * * * *

(ii) If a taxpayer computes gross income from mining under the provisions of paragraph (d) of this section, the cost of purchased transportation to the customer (as defined in subdivision (iii) of this subparagraph) shall be excluded from the gross sales of his first marketable product or group of products (after any adjustments required by subparagraph (1) of this paragraph), and from the denominator of the proportionate profits fraction, so as not to attribute profits to the cost of that transportation. Similar transportation cost adjustments may be made, if appropriate, in the case of other methods of computation which are based on the taxpayer's costs. For the treatment of costs and profits attributable to transportation which is not purchased transportation to the customer as defined in subdivision (iii) of this subparagraph, see paragraph (d)(3)(i) of this section.

(iii) For purposes of this section, the term "purchased transportation to the customer" means, in general, nonmining transportation of the taxpayer's minerals or mineral products to the customer—

(a) Which is not performed in conveyances owned or leased directly or indirectly, in whole or in part, by the taxpayer.

(b) Which is performed solely to deliver the taxpayer's minerals or mineral products to the

customer, rather than to transport such minerals or products for packaging or other additional processing by the taxpayer (other than incidential storage or handling), and

(c) With respect to which the taxpayer ordinarily does not earn any profit.

For purposes of the preceding sentence, transportation which is performed by a person controlling or controlled by the taxpayer (within the meaning of paragraph (j)(1) of this section) shall be deemed to have been performed in conveyances owned or leased by the taxpayer unless it is established by the taxpayer that the price charged by the controlling or controlled person for such transportation constitutes an arm's-length charge (under the standard described in paragraph (b)(1) of § 1.482-1). The term "purchased transportation to the customer" includes transportation to a warehouse, terminal, or distribution facility owned or operated by the taxpayer, provided that such transportation is performed under the conditions described in the first sentence of this subdivision. A taxpayer will not be deemed ordinarily to earn a profit on transportation merely because charges for the transportation are included in the stated selling price, rather than being separately stated or segregated from other billing. A taxpayer will not be deemed ordinarily to earn a profit on transportation if the rates for the transportation constitute an arm's-length charge ordinarily paid by shippers of the same product in similar circumstances. If a taxpayer computes gross income from mining under the provisions of paragraph (d) of this section, the term "purchased

transportation to the customer" refers to transportation which conforms to the other requirements of this subdivision and which is performed to transport the taxpayer's first marketable product or group of products (as defined in paragraph (d)(4)(iv) of this section) rather than to transport minerals or mineral products which do not yet constitute the taxpayer's first marketable product or group of products.

* * * * *

(g) *Nonmining processes*—* * *

* * * * *

(3) *Transportation for the purpose of marketing or distribution; storage.* Transportation the primary purpose of which is marketing, distribution, or delivery for the application of only nonmining processes shall not be considered as mining. Nor shall transportation be considered as mining merely because, during the course of such transportation, some extraneous matter is removed from the ore or mineral by the operation of forces of nature, such as evaporation, drainage, or gravity flow. Similarly, storage or warehousing of manufactured products shall not be considered as mining. The preceding sentence shall apply even though, during the course of such storage or warehousing, some extraneous matter is removed from the ore or mineral by the operation of forces of nature, such as evaporation, drainage, or gravity flow.

(4) *Manufacturing, etc.* The production, packaging, distribution, and marketing of manu-

factured products, and the processes necessary or incidental thereto, are nonmining processes.

* * * * *

§ 1.613-5 *Taxable income from the property.*

* * * * *

(c) *Treatment of particular items in computing taxable income from the property.* * * *

* * * * *

(4) * * *

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(ii) A reasonable portion of the expenses of selling a refined, manufactured, or fabricated product shall be subtracted from gross income from the property. Such reasonable portion shall be equivalent to the typical selling expenses which are incurred by unintegrated miners or producers in the same mineral industry so as to maintain equality in the tax treatment of unintegrated miners or producers in comparison with integrated miner-manufacturers or producer-manufacturers. If unintegrated miners or producers in the same mineral industry do not typically incur any selling expenses, then no portion of the expenses of selling a refined, manufactured, or fabricated product shall be subtracted from gross income from the property when determining the taxpayer's taxable income from the property.

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